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2009 Laurea Leppävaara

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On Demand Guarantees in Iran

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Business Management Programme
Thesis
February, 2009

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Year	2009	Pages	46
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This thesis examines on demand guarantees in Iran concentrating on bid bonds and performance guarantees. The main guarantee types and related terms are defined to be able to understand the issues related to guarantees better. Guarantees are an important part of international trade finance and often required by the foreign customers of the suppliers. Guarantees are a risk management option.

This thesis is made for companies which run a business in Iran and are therefore obligated to issue guarantees in favour of their customers. The Iranian bid bonds and performance guarantees include many features which are important to know and understand well before issuing guarantees.

The main issues to remember when issuing Iranian bank guarantees are the automatic extendable clause, the demand for payments without statements, releasing the guarantees and the laws of Iran. The customers can automatically extend the guarantees as many times as they wish and therefore the guarantees often remain valid for a long time. The customers are also able to demand payment without any statements and that is why every claim has to be investigated very carefully.

The main sources of this thesis have been Bertrams' book Bank Guarantees in International Trade and interviews. Two interviews clarify the point of view of international banks' representatives and one interview concentrates on experiences of a global company's representative. The interviews bring tacit knowledge to this thesis.

This thesis also includes the Iran section which clarifies Iran as a country and business in Iran. In 2008 this subject was very topical. There have been many sanctions and regulations made against Iran and Iranian banks during the year 2008 and there is a big possibility of new sanctions in the near future. There are banks with which it is forbidden to work. Also the laws of Iran bring an interesting point of view to Iranian guarantees.

Key words guarantee, bid bond, performance guarantee, Iran

Ahvenainen Laura

On demand -takaukset Iranissa

Vuosi 2009

Sivumäärä 46

Opinnäytetyön aiheena on esitellä on demand -takauksia Iranissa keskittyen tarjous- ja toimitustakaukseen. Opinnäytetyön tavoite on käsitellä tärkeimmät takaustermit sekä käsitteet, joita takausten yhteydessä käytetään ja on hyvä ymmärtää takauksia annettaessa. Takaukset ovat yleinen tapa kansainvälisessä kaupassa ja monet ulkomaiset yritykset vaativatkin takauksia toimittajiltaan. Takaukset toimivat yhtenä riskienhallintakeinona.

Opinnäytetyön tarkoituksena on luoda selkeä kuva iranilaisista takauksista yrityksille, jotka harjoittavat liiketoimintaa Iranissa ja näin ollen ovat velvoitettuja antamaan takauksia asiakkaidensa hyväksi. Iranilaiset tarjous- ja toimitustakaukset sisältävät erityispiirteitä, jotka on hyvä ymmärtää ennen takausten antamista.

Tärkeimmät huomioon otettavat seikat iranilaisissa takauksissa ovat automaattinen pidennyslauseke, maksuvaatimukset ilman erillisiä lausuntoja, takauksen vapautuminen sekä Iranin laki. Asiakkaat voivat pidentää takausta vedoten automaattiseen pidennyslausekkeeseen ilman erillistä syytä, jolloin takauksen voimassaolo yleensä pidentyy useita kertoja. Asiakkaalla on myös mahdollisuus tehdä maksuvaatimus ilman erillisiä lausuntoja. Kaikki vaatimukset tulee tästä johtuen käydä läpi tarkasti ennen maksamista.

Opinnäytetyössä on hyödynnetty alan kirjallisuutta sekä haastatteluja. Tärkein kirjallisuuslähde työssä on Bertramsin kirja Bank Guarantees in International Trade. Opinnäytetyöhön liittyen on tehty kaksi haastattelua kansainvälisten pankkien edustajille sekä haastattelu kansainvälisen yrityksen edustajalle. Haastattelujen avulla työhön on saatu myös hiljaista tietoa.

Lisäksi työssä käsitellään Irania sekä maana että liiketoiminnan kannalta. Iran on tällä hetkellä hyvin haastava maa harjoittaa liiketoimintaa johtuen maata koskevista pakotteista ja sanktioista. Aihe on hyvin ajankohtainen, koska sanktioita ja pakotteita on määrätty vuoden 2008 aikana monia ja niitä tullaan todennäköisesti määräämään vielä lisää ennen kuin tilanne Iranissa rauhoittuu. Muutamien iranilaisten pankkien kanssa toimiminen on kiellettyä. Myös Iranin laki tuo erityisiä haasteita takauksiin.

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1 Introduction

Making a thesis is a long and exciting project and it gives a new point of view to its writer and its readers. Please step into the world of on demand guarantees in Iran.

1.1 Subject

The subject “On demand guarantees in Iran” has been chosen based on the needs in Company X. There has been a need to investigate this subject more closely to understand Iranian guarantees better. This subject has been accepted inside the Company X but this thesis can also be used in other global companies. This thesis is written in English because the company is global and that way it can be used to widen also local representatives’ know-how.

Iran is investigated as a country and from the business point of view. Iran is a very challenging country to make business in at the moment. The current situation of the country is quite unstable which makes it difficult to enter the market and run a business in Iran but it makes it also very interesting. The current situation between Iran and the United States of America is very difficult. The United States of America has not accepted companies which export goods to Iran after Mr President Bush’s speech in January 2002.

This thesis studies guarantee issues overall i.e. terms and phenomenon and describes Iran as an export country. The main focus is in bid bonds and performance guarantees in Iran. The main point is to clarify the special characters of the guarantees in Iran, amendments (extensions, changes in the guarantee amount and in the wording etc.), extend or pay -requests, demand for payments and cancellations. In addition the thesis explains the most important special features of the laws of Iran concerning the guarantees. Guarantees are often required by the customers when exporting goods to Iran.

Some risk points when having a business in Iran are taken into account but those are not investigated further. It is also essential to remember the point that a guarantee makes smaller the risk of the beneficiary i.e. guarantees are a risk management option.

The world of guarantees is still quite unclear. There are no global rules or regulations on how the guarantees should be handled. Therefore national laws often give the guidelines to guarantee issues. This thesis includes only country specific information regarding guarantee laws and regulations of Iran.

1.2 Mission

Guarantees are an essential part of trade finance and export business. The customers abroad often require guarantees for the safety of the advance payments and the performance of the goods. To be able to issue guarantees it is important to have an overall picture of the different kind of guarantees and the content of the guarantee wordings. It is essential to remember that guarantees always relate to contracts and cannot be independent.

This thesis is made to help to understand on demand guarantees overall and to look deeper into guarantees in Iran. This thesis is made for companies which export goods to Iran and are therefore obligated to issue guarantees in favour of their customers.

1.3 Methods

Literature and interviews are two main sources of information in my thesis. It has been a challenge to find professional literature about guarantees. The main source of information used in this thesis is Bertram's book "Bank Guarantees in International Trade".

This thesis includes interviews as a reference, two for international bank's representative and one for Company X's representative. It is important to also bring a bank's point of view to this work to enlarge the whole subject. Two interviews clarify the banks' side. The third interview inside the Company X widens the perspective from the field, the local representative will give his opinion on the business in Iran especially guarantee related issues. The representative in the field has tacit knowledge of Iran and that should be used to clarify the situation more accurately. Since this subject is still very sensitive Company X and banks stay anonymous.

Bank A's representative has worked in international trade finance with guarantee related issues for many years and has wide knowledge of guarantees. Bank B's representative, Mr Peter Wancke has also worked among trade finance related issues both in banks and companies. He is a professional in this field. Company X's representative has worked with Iranian companies for many years and has experience of the operations of the Iranian companies and banks.

The interviews were made as open interviews. The results are reliable and valid because the interviewer was able to make more in-depth questions during the interview and concentrate on the most important issues. The environment was open for communication. The interview questions can be found from Appendixes 1-3.

1.4 Structure

This thesis consists of nine chapters. The following paragraphs describe the content of this thesis and give an overview of the subjects studied in this work.

The first chapter (1 Introduction) introduces the subject and the reason for this thesis. The subject is defined and framed.

The second chapter (2 Iran) investigates Iran as a country. Iran is a very interesting and difficult country to make business and issue guarantees. This chapter consists of the basic information of Iran, the main points to remember when having business in Iran, basic information of Iranian banks and basics of the laws of Iran. There are also some regulations and sanctions which are taken into consideration.

The third chapter (3 Terms) consists of the main terms in guarantee related issues. The thesis defines the following terms: guarantee, bid bond, advance payment guarantee, performance guarantee, warranty, conditional guarantee, on demand guarantee, applicable law, bank guarantee, direct guarantee, indirect guarantee and SWIFT. To be able to understand the world of guarantees it is important to be familiar with the terms above.

The fourth chapter (4 Bid bond) goes deeply into the bid bond related issues. First the bid bond needs to be issued and there are many things to remember. The wording of the bid bond in Iran has special characteristics which are studied and specified in this chapter. Most of the special characteristics are related to the laws of Iran. Often when the bid bond is issued there are amendments to be made, the form of amendments are defined in this chapter. When a bid bond is not needed anymore it has to be cancelled. However it is not always as easily done as said.

The fifth chapter (5 Performance guarantee) concentrates on performance guarantees. Compared to bid bonds performance guarantees have their own special characteristics which are defined in the fifth chapter. The issuance, amendments and the cancellation of a performance guarantee are discussed closely. Also the laws of Iran are commented shortly.

The sixth chapter (6 Bank's counter guarantee) describes the main issues in counter guarantees in favour of Iranian banks. Those are also closely related to the principal debtor since it is always the final account party.

The seventh chapter (7 Costs) specifies the cost items related to the issuance of guarantees and gives an example of the prices.

The eighth chapter (8 Demand for payment) explains the situation when something has gone wrong and the guarantee has been claimed. Claims are quite unusual but have to be taken seriously and each case has to be checked very carefully. The laws of Iran and the regulations bring an interesting aspect to the claims.

The ninth chapter (9 Conclusion) compiles the most important points of the thesis, what are the main points to remember of on demand guarantees in Iran, analyses the achievements and clarifies if there is something to be developed or could be handled more closely.

2 Iran

2.1 Country information

The following paragraphs include key information of Iran, officially Islamic Republic of Iran. The capital city of Iran is Teheran. In 2007 population of Iran was 70 900 000 people. The main religious group in Iran is Shi'a Muslims (89 %). The remaining eleven percent comprise of Sunna Muslims (9 %) and other religions (2 %). (Wilén 2008, 4.)

Iran is a part of the Middle East. The Middle East consists of the following countries: Afghanistan, Bahrain, Egypt, Iran, Iraq, Israel, Jordan, Kuwait, Lebanon, Pakistan, Palestinian territories, Oman, Qatar, Saudi Arabia, Sudan, Syrian Arab Republic, United Arab Emirates, and Yemen. Three religions affects in Middle East; Christianity, Islam and Judaism. Conflicts between religions haven't been avoided during the centuries. Middle East has been and is strategically, economically, politically, culturally and religiously a sensitive area. Every country has its own specific characters but yet those are quite similar. (Wikipedia: Middle East 2008.)

2.2 Economy of Iran

Key information in 2007:

- Currency: IRR, rial
- Main export products: Crude oil and natural gas, village agriculture
- Main import products: Parts and accessories of cars, gold, machines and devices
- Main export countries: China, Japan, Turkey, Italy and South-Korea
- Main import countries: China, Germany, the United Arab Emirates, South-Korea and Russia
- Trade with Finland: Export from Finland 123.7 million EUR import to Finland 2,3 million EUR, balance of trade for Finland 121,4 million EUR surplus

(Wilén 2008, 5.)

Most of the companies are state owned and have an advantage compared to private companies. The structures of the companies are old and the decision making is complicated. Country has low foreign debt and large FX reserves. Iran is very nuclear ambition country which complicates its relationship to other countries. The current situation of the country and poor domestic economy generates unsatisfactory among people. (Engzell 2008.)

2.3 Business in Iran

As every country Iran also has some pros and cons regarding the business in Iran. Strengths are for example large number of consumers, large number of highly educated students and high demand for infrastructure and accommodation. Weaknesses are for example low gross domestic product, state owns many large-scale enterprises (as oil companies), Iranian government regulates economy more than European governments, demand is highly dependent from oil incomes and reliable market intelligence is difficult to get. (Wilén 2008, 6.)

One example of the regulations in Iran is the prohibited import and export goods described below.

On the basis of rules and regulation of Iran, entrance of some goods and or its export is totally prohibited. Some of those goods are as follows:

1. Alcoholic drinks
 2. Gambling tools
 3. Weapons, ammunition and explosive goods
 4. Narcotic drugs
 5. Magazines, photos, films and snaps and those goods, which are against religious and national dignity of the country.
 6. Any type of writings against the official religion of the country and or discipline disturbance and public purity and national dignity.
 7. Various type of goods which have legitimate and legal precipitance and or this import and export has not been prohibited according to the customs tariff table or special rules.
- (Islamic republic of Iran's customs 2008.)

2.4 Sanctions

Sanctions against Iran have changed the exporting of some countries. For example in Germany the export to Iran has dropped in the past three years. The total amount of guarantees issued for trade with Iran has fallen from €5.8bn to €5.2bn since 2005. Germany has been the big-

gest exporter to Iran for the past 30 years but the place has probably been taken over by China. (Benoit 2008.)

During the year 2008 there have been many regulations and sanctions made against Iran. Therefore there is a big possibility that in the near future new sanctions will be set down either by the United Nations, the United States of America or the European Union. The regulations given by the United Nations are followed very closely in the European Union.

2.4.1 United Nations Security Council: Resolution 1803

United Nations Security Council's resolution on 24th March 2007 tightens the restrictions on Iran's proliferation-sensitive nuclear activities, increases vigilance over Iranian banks and states inspect cargo. New regulation includes freeze of assets of further companies and individuals, inspection of cargo to and from Iran on Iranian vessels and aircrafts, states paying attention to public financial support for trade with Iran and over the activities of their banks with Iranian bank especially with Bank Melli and Bank Saderat. (United Nations Security Council 2008.)

2.4.2 EU regulation 423/2007

EU regulation 423/2007 of 19th April 2007 concerning restrictive measures against Iran is related to the United Nations Security Council's (UNSC) decision on March 2007 to freeze assets, restrict arm sales and financial assistance and freeze Iranian Bank Sepah and its London branch. The regulation includes forbidden goods (related to Iran's nuclear weapons programme), goods that need approval, goods that are freely exported to Iran and persons' frozen assets, forbidden organizations and Iranian Bank Sepah. In Finland this regulation is supervised by Ministry of Foreign Affairs. (European Union 2007.)

This regulation has affected also to Iranian guarantees since the mid of 2007. According to Bank A's representative (2008) when the principal debtor applies guarantee and sends the needed information to issue a new guarantee in favour of Iranian beneficiary the bank needs to also have a certificate that the supplier corresponds to the regulations.

The certificate can be for example:

"We, ... (the company), certify that the items exported in ... (the project description) are not goods, materials and technology prohibited by the United Nations and/or the European Union in the frame of the restrictive measures against Iran".

2.4.3 EU regulation 1110/2008

EU regulation 1110/2008 of 10th November 2008 amends the regulation 423/2007. The new regulation includes new and amended restrictions regarding restricted goods, institutions and persons. The regulation restricts co-operation with Bank Saderat. The regulation also forbids all extension or payments of commissions where Bank Sepah and Bank Melli are involved until further notice. (European Union 2008.)

2.4.4 The United States of America

The United States of America has had trade sanction to Iran for a long time. The relationship between the United States of America and Iran has been quite tense because of the oil situation, World Trade Center -terrorist attacks in 2001 and nuclear programs in Iran. At the moment US bank are prohibited to deal directly with Iranian banks (Engzell 2008.)

Sanctions that has been in force since October 2007:

- Total US embargo against Bank Melli, Bank Mellat and Bank Saderat
 - Restrictions on USD payments
 - Revolutionary Guards and Ministry of Defence
 - US warns all non-US companies not to deal with Iranian companies
- (Engzell 2008.)

U.S. Department of Treasury has amended Iran's U-Turn Licence on 6th November 2008. Earlier U.S. financial institutions were authorized to process certain funds transfers for the direct or indirect benefit if Iranian banks, other persons in Iran or the Government of Iran, providing such payment were initiated offshore by a non-Iranian, non-U.S. financial institution and only passed through the U.S. financial system to another offshore, non-Iranian, non-U.S. financial institution. Starting 6th November 2008 U.S. financial institutions are no longer allowed to process the U-turn transfers. Earlier the U-turn transfers were prohibited to state-owned banks Melli, Mellat, Sepah, Future Bank and the Export Development Bank of Iran. Starting 6th November 2008 the U-turn transfers are prohibited also to all remaining Iranian banks, including the Central Bank of Iran. (U.S. Department of Treasury 2008.)

2.5 Finnish companies in Iran

Finnish companies have run a business in unpreferred countries by the western world for many years. In January 2002 the president of the United States Bush gave a speech about the "Axis of Evil" countries and pointed out that no country should have business with them. Finnish companies have exported goods to undemocratic countries in the years 2002 -2007 for

over 858 million Euros. During the first half-year 2008 Finland has exported goods to Iran for 105 million Euros. (Taipale 2008.) Potential lines of business for Finnish companies are telecommunication, chemical agent and products and industrial machines and devices (Wilén 2008, 6).

2.6 Banks in Iran

The banking sector is strictly supervised by the Central Bank of Iran. Private Banks are growing but still the freedom is very limited by the Central Bank. The biggest banks are state owned and dominate the banking sector. Operations of state owned banks are bureaucratic and strictly regulated. In Iran there are no foreign banks. (Engzell 2008.)

The Central Bank of Iran (CBI) was established in 1960 to design and implement the monetary and credit policies accordance with the general economic policy of the country. The four main targets are maintaining the value of national currency, maintaining the equilibrium in the balance of payments, facilitating trade-related transactions and improving the growth potential of the country. To achieve these targets the CBI has to fulfil the following points: issuance of notes and coins, supervision of banks and credit institutions, formulation and regulation of foreign exchange policies and transactions, regulation on gold transactions, formulation and regulation on transactions and inflow/outflow of Domestic currency. (Central Bank of Iran: General information 2008.)

There are four types of banks and credit institutions in Iran: Commercial Government Owned Banks, Near-bank, Private Banks and Specialized Government Banks. The main banks handling foreign guarantees are commercial government owned banks i.e. Bank Mellat, Bank Melli Iran, Post Bank of Iran, Bank Refah, Bank Saderat Iran, Sepah Bank and Tejarat Bank. (Central Bank of Iran: Banks and credit institutions 2008.)

Compared to European banks the operations of the Iranian banks are much more regulated and controlled. The banks have to have permission from CBI in order to issue guarantees. CBI requires that a guarantee includes specific information otherwise the guarantee is not operative. (Bank A's representative 2008.) Banks in Middle East are regulated to use standard or approved guarantee and counter guarantee wordings by virtue of state regulations (Bertrams 1996, 28).

The co-operation with Iranian bank operates well and there are no significant differences compared to European banks. To be able to work with an Iranian bank the instructing bank has to be a correspondent bank. Banks discuss with SWIFT messages but with Iranian banks the contents of the SWIFT messages related to guarantees and counter guarantees are very

restricted. The message has to include exactly the needed information otherwise the Iranian bank requires amendment. The only significant difference in Iranian banks is the different workweek and the difference in time compared to Finland and Finnish banks. These things have to be remembered when dealing with Iranian institutions. (Bank A's representative 2008.)

2.7 Law of Iran

Iranian legal system is based on Sharia (Islamic law). The constitution of the Islamic Republic defines the judiciary in Iran as an independent power. The entire legal system is supervised by the Ministry Justice and head of the Supreme Court. (Wikipedia: Law of Iran 2008.)

“Sharia controls the family and property interests of Muslims in countries where personal law is determined by religion, and it is the law referred to in such matters concerning Muslim citizens of such countries by courts in jurisdictions where nationality is the criterion for personal law. Some predominantly Muslim countries apply Sharia at least in part in matters of criminal and commercial law; Islamists argue that Sharia is a complete set of laws and that no man-made laws have a place in the Muslim State.” (Law and technology resources for legal professions 2002.)

The section 14 of the civil code of the Islamic Republic of Iran clarifies guarantees. A contract of a guarantee is defined as such that a party takes the responsibility of another party's obligations. It is not necessary for the guarantor to know the amount, the details and the conditions. After the guarantee has been made validly the obligation of the guarantor comes into force. The beneficiary can make a claim if the factors defined in the guarantee are met; if there are no conditions the beneficiary is able to claim the amount during the guarantee period. Only the beneficiary is obligated to release the contract of the guarantee. (Alavi and Associates: The civil code of the Islamic Republic of Iran)

Bank Markazi Iran shall, for the proper implementation of the monetary system, have the authority to intervene in and supervise monetary and banking affairs as follows: by determining the maximum amount of commitment on the part of banks emanating from opening letters of credit, effecting endorsements or issuing guarantees, as well as the type and amount of collateral for such commitments. (Central Bank of Iran: Monetary and Banking Law of Iran 2008.)

Bank Markazi Iran, as the authority responsible for the monetary and credit system of the country, shall fulfill the following functions; formulation of regulations pertaining to foreign exchange transactions, commitments and guarantees with the approval of the currency and

credit council, and also control of foreign exchange transactions (Central Bank of Iran: Monetary and Banking Law of Iran 2008.)

3 Terms

It is important to understand the meanings of the basic words regarding guarantees to be able to understand the content of the guarantees. The name of the guarantee does not always directly explain the guarantee type and therefore it is always important to concentrate on the content of the wording. The following part explains the main terms in the fascinating world of guarantees.

3.1 Guarantee

Guarantees are always related to contracts between the supplier (principal debtor) and the customer (beneficiary) and cannot be issued independently. Although the content of the guarantee i.e. terms and conditions defines the beneficiary's right to claim the payment. (Bertrams 1996, 9.)

Guarantees are most often issued by banks, except in America. Guarantees in America are typically issued by insurance companies. Guarantees issued by banks and insurance companies are the most safe ones from beneficiary's point of view and therefore the beneficiaries often require bank or insurance company guarantees. Companies can also issue corporate guarantees but the beneficiaries do not always accept those. (Bertrams 1996, 6.) Corporate guarantees are much cheaper compared to bank guarantees and therefore companies should prefer those instead of bank guarantees whenever it is possible.

Guarantees can be divided into commercial guarantees and non-commercial guarantees. Commercial guarantees are related to commercial contract between the supplier and the customer. The most common guarantee types related to commercial contracts are defined below in the following paragraphs. Non-commercial guarantees are for example rental-, customs- and VAT guarantees. Non-commercial guarantees are not directly related to commercial contracts but those are obligatory to be able to make a business. (Bertrams 1996, 29-36.) Non-commercial guarantees are not studied further in this thesis.

The following Figure 1 clarifies which commercial guarantees are used in which part of the contract. The horizontal axis reflects the contracts different stages and the vertical axis the percentage amount of the contract. (Helppi & Paloheimo 2005, 63.) The guarantee types are defined in the paragraphs below.

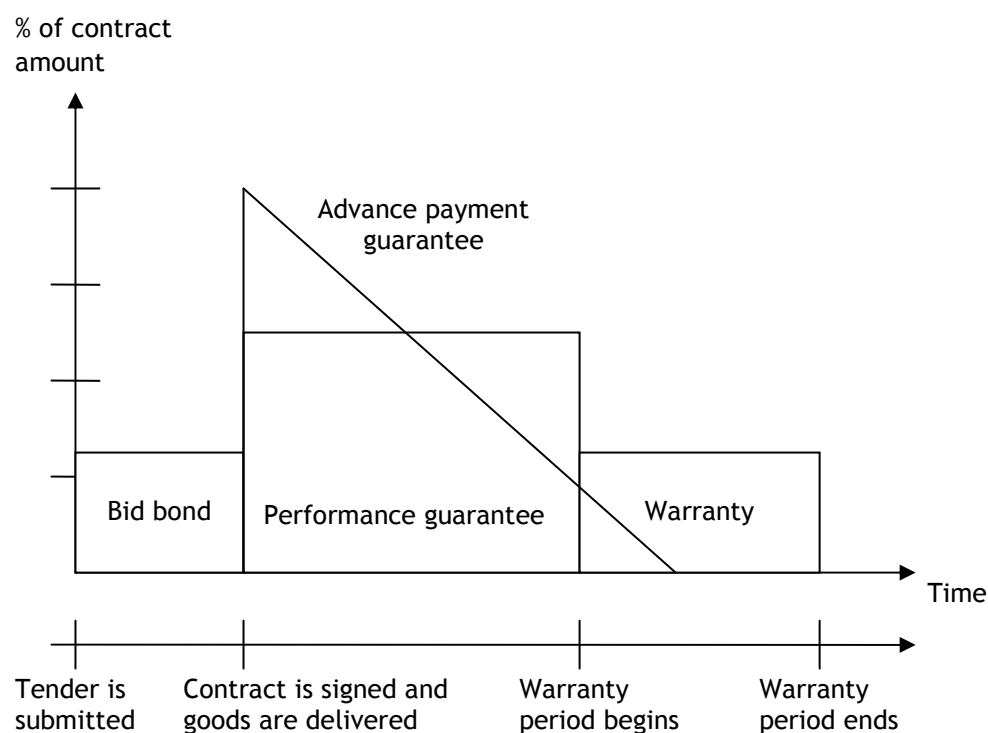


Figure 1

(Helppi & Paloheimo 2005, 64.)

According to Company X's representative (2008) guarantees are issued to cover the risks the customer takes when having business with new or unknown suppliers. The customer wants to have a security that they may enforce their rights for compensation in an easy manner. Bank A's representative believes that the current unstable market situation will increase the amount of new guarantees.

3.1.1 Bid bond

Bid bonds are very common in international trade finance when the beneficiary organises a competitive bidding. Bid bond is to secure the beneficiary in case the account party withdraws the tender, does not sign the contract or affects against the tender conditions. Bid bonds are normally 2 -5 per cent of the contract value. (Selin 1997, 64.)

The beneficiary is allowed to claim the bid bond if any of the obligations above is not fulfilled. The payment compensates the loss of time and money. Bid bonds have normally fixed expiry date when the guarantee expires. However sometimes the tender process is prolonged or the submission date has been drawn out and the expiry date has to be extended. (Bertrams 1996, 30.) Bid bonds and extension are handled more closely in chapter 4.

3.1.2 Advance payment guarantee

With large contracts the parties quite often agree, that the customer pays a certain percentage to the supplier when the contract has been signed. The guarantee amount is the same as the advance payment amount, usually 10 - 30 per cent of the contract value. The supplier is able to buy materials and pay salaries with the advance payment amount and on the other hand the customer gets security if the supplier cannot deliver the goods or complete the work which has been agreed. (Nordea 2006, 12.)

3.1.3 Performance guarantee

A performance guarantee issued in favour of the beneficiary is to protect the beneficiary against the failure of the principal contract to meet obligations specified in the contract timely, completely and properly. The guarantees are usually 5 - 10 per cent of the contract value. The guarantee is valid until the goods delivered according the contract terms or as stated in the guarantee wording. (Selin 1997, 65.)

“For example, a contractor may issue a bond to a client for whom a building is being constructed. If the contractor fails to construct the building according to the specifications laid out by the contract, the client is guaranteed compensation for any monetary loss.” (Investopedia 2008.)

The performance guarantee does not always only cover the delivery of the goods but it may also include installation, contractual warranty obligations during the warranty period, ancillary and all other obligation which are part of the principal contract. If the performance guarantee covers also the warranty period, it is important not to issue a warranty guarantee. To have duplicate guarantees for the same contract enlarges the risks of the principal debtor. (Bertrams 1996, 30-31.) If the performance guarantee covers also warranty period, the guarantee amount should decrease down to five percent of the contract value. Performance guarantees and the performance guarantee wordings are handled more closely in chapter 5.

3.1.4 Warranty

Warranty guarantee covers the supplier's obligations after the goods have been delivered or the work has been done, including the proper functions of the equipments or machines, services and repairings during the warranty period. If the supplier fails to fulfil one of the above mentioned obligations the beneficiary has a right to claim the payment under the guarantee. Warranty guarantees are usually 5 - 10 per cent of the contract values. (Selin 1997, 65.)

3.1.5 Conditional guarantee

Conditional guarantee is quite a complicated term. Conditional guarantees are suretyships and “as for our own debt” -guarantees. On demand guarantees which require documents or statements are also kind of conditional guarantees but not so clearly as the terms mentioned above.

According to HSBC bank conditional guarantee is “A guarantee that does not become payable unless the guarantor has verified that the applicant is in breach of its contractual obligations and that as a result of that breach the beneficiary has suffered or incurred a loss or damages” (HSBC bank: Glossary terms). A suretyship is a conditional guarantee under the laws of England. It can be defined as jointly and severally the parties are responsible for the guarantee and both parties sign the agreement. (Bank A’s representative 2008.)

A conditional guarantee can also be called “as for our own debt” guarantee. “As for our own debt” guarantee is a guarantee according which the guarantor is responsible for the principal debt like the principal debtor. (Kärävä, Riihimäki & Kärävä 2002, 437.) Conditional guarantees require third-party documents, or an arbitral, or court decision. The beneficiary has to specify the breach more closely than with on demand guarantees. The bank is obligated to hold the payment until the liability to pay under the underlying contract has been solved out. (Bertrams 1996, 44.)

3.1.6 On demand guarantee

On first demand -guarantees give an advantage for the beneficiary. There are two different types of on first demand guarantees, first is introduced in this paragraph (on first demand guarantee with statement) and the second in the next paragraph (on first demand guarantee without statement). The guarantor is obligated to pay the guarantee amount to the beneficiary after the first demand has been made if the principal debtor has not performed according to predefined specifications. The beneficiary has to give written statement and specify which part the principal debtor has not fulfilled. (Aurejärvi & Hemmo 2004, 156.) Even though this kind of guarantee is called on demand guarantee there is a condition to be fulfilled before the beneficiary has a right for the payment.

According to Aurejärvi and Hemmo (2004, 157) on first demand -guarantees are very common in international trade and in building a contract. The other types of on first demand -guarantees have to be paid on first written demand without any statement whether the claim

is justified or not. The principal debtor can demand the payment back later if the claim has been unfounded.

A first demand guarantee with or without statement is highly risky from the principal debtor's point of view. The beneficiary may call the guarantee and receive the payment at any moment he feels that the supplier has failed to fulfil its obligations. The beneficiary is also able to put pressure on the supplier to perform the contract on time and properly. (Bertrams 1996, 42.)

3.1.7 Applicable law

The guarantee is governed by and construed in accordance with the laws of the issuing bank's country if nothing else has agreed. The law can be also mentioned in the end of the guarantee wording and then also the place of jurisdiction is specified. (OP-Pohjola: Ulkomaankaupan pankkipalvelut -guide 31.)

The applicable law can be defined as follows:

"This Guarantee shall be governed by and construed in accordance with the laws of (country) and shall be subject to the exclusive jurisdiction of the (country) courts."

"This guarantee is subject to (country) law and the place of jurisdiction is (city)."

In most countries there is no specific legislation concerning guarantees. Middle East countries instead have mandatory regulations and laws which have to be taken into consideration when having a guarantee. Regulations include mandatory instructions mainly for Governmental companies for example specific guarantee wordings issued by local bank, conditions of payment, validity. Basically foreign exporters have no option to change the regulations and therefore it is important to understand the liabilities the regulations bring. (Bertrams 1996, 27.)

The instructing bank's counter guarantee in favour of the issuing bank (local bank) is slightly more complicated since there are two different guarantees involved. The guarantee issued by the local bank applies to the local law if nothing else has agreed. The counter guarantee issued by the instructing bank in favour of the issuing bank applies the local law of the instructing bank if nothing else has been agreed. In some countries for example in Iran, Turkey and Jordan the instructing bank must always state the law of the issuing bank's country in the counter guarantee. (Nordea 2006, 23.)

The applicable law affects a lot to the interpretation of the guarantee. The main impacts concern the demand for payments and the validity of the guarantee. Therefore when issuing local guarantees under the local laws the affects should be know beforehand to avoid the surprises in the future.

3.2 Bank guarantee

Bank guarantee is a product of banks. When a company wants to open a guarantee a bank debits a commission and requires a counter guarantee. The counter guarantee is to cover the risks the bank takes and the liabilities that may arise if the original guarantee is claimed. This way the bank holds the right of recourse. (Hemmo 2001, 182 & 185.)

The counter guarantee covers all the payments the bank has paid as a guarantor and an interest fee from the payment day to the day the princibal debtor pays back. It also defines the specific provisional charges. Costs are defined more closely in chapter 6. (Kärävä etc. 2002, 453.)

3.2.1 Direct guarantee

Direct guarantee is the easiest way to issue a bank guarantee. Three are three parties involved; a supplier/principal debtor, a customer/beneficiary and an issuing bank. Between the supplier and the customer there is a signed supply contract or other contract. When the customer requires a direct bank guarantee, the supplier instructs the bank to issue the guarantee in favour of the beneficiary. After issuing the guarantee the bank will forward it either directly to the beneficiary by mail or courier service or to the principal debtor for further handling. (Nordea 2006, 6-7.) The Figure 2 demonstrates the situation of the direct guarantee.

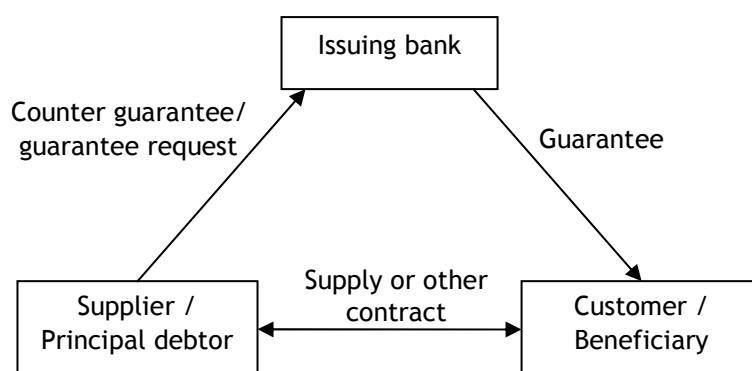


Figure 2

(Bertrams 1996, 13.)

Direct guarantees can also be forwarded to the beneficiary through a foreign bank by telex or SWIFT. The foreign bank's role is to confirm the authenticity of the message and deliver the guarantee to the beneficiary without any liabilities or obligations on their part. (Nordea 2006, 7.)

3.2.2 Indirect guarantee

Compared to direct guarantees indirect guarantees are more complicated from the guarantee side. There are four parties involved; a supplier/principal debtor, a customer/beneficiary, an instructing bank and an issuing bank. The principal debtor advises the principal's bank/instructing bank to request the bank in beneficiary's country to issue a guarantee in favour of the beneficiary. The instructing bank has to give a counter-guarantee to the issuing bank. (Nordea 2006, 7.) The Figure 3 clarifies the indirect guarantee more closely.

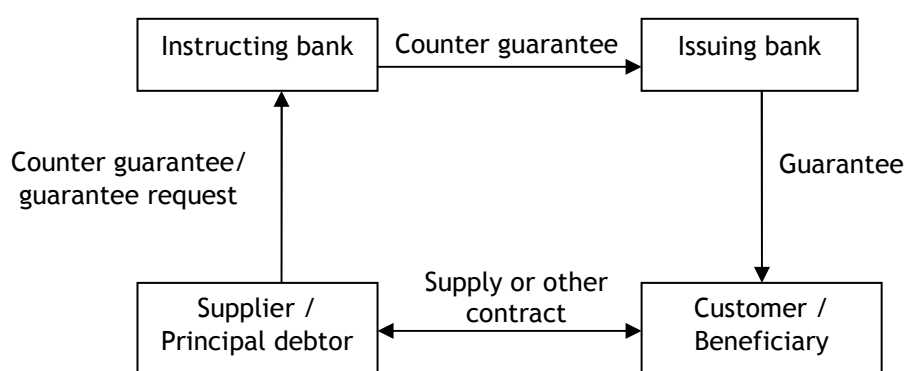


Figure 3
(Bertrams 1996, 15.)

Indirect guarantees are often required in Middle Eastern and Arab countries and when the beneficiary is public or a government entity. Indirect guarantees favor the beneficiaries since the guarantees are governed by the laws of the issuing banks' countries and subjects to issuing banks' customs and practices. (Nordea 2006, 7-8.) Indirect guarantees are more expensive compared to direct guarantees because there are two banks issuing fees.

3.2.3 Issuing a guarantee

When issuing a bank guarantee the bank has to have the following information in order to be able to issue the requested guarantee:

- Applicant company's contact information: Official company name, address and company's ID code

- Beneficiary company's name and address, telex number, contact person
- Copy of the main contract: for example contract, order, confirmation of order, pro-forma invoice, invoice or promissory note
- Information of what the guarantee covers
- Guarantee currency and amount
- Validity
- Guarantee type:
 - Conditional or first demand guarantee
 - Bid bond, advance payment guarantee, performance guarantee, warranty guarantee or other
- Guarantee wording if it has been agreed in the contract
- Beneficiary's bankers details if the guarantee is advised through local bank by SWIFT (OP-Pohjola: Ulkomaankaupan pankkipalvelut -guide 32.)

A company which uses guarantees rarely in their business has to apply a credit decision from the bank before to be able to get the guarantee. The bank evaluates the company based on the risk. A company whose business requires guarantees regularly has a credit limit with the bank. (Mr Wancke 2008.)

A line of credit is an agreement between the bank and the company that the company is able to use the credit line up to a specified amount. Credit lines are divided to committed and noncommitted. Noncommitted credit line is an informal arrangement that allows the company to use the limit without going through the normal paperwork. Committed credit lines are more formal arrangements that normally include a commitment fees paid by the company to the bank. (Ross, Brealey & Myers 2008, 642.)

3.2.4 SWIFT

SWIFT is Society for Worldwide Interbank Financial Telecommunication used by banking organisations, securities institutions and corporate customers. With the SWIFT system parties can connect and exchange financial information securely and reliably. A SWIFT -message is a standard format of Bank Identifier Codes approved by International Organization for Standardization (ISO). SWIFT messages are automated and standardised financial transactions eliminating inefficiencies from their operations and lowering costs. (SWIFT 2008.)

4 Bid bond in Iran

The guarantees in favour of Iranian customers are almost every time issued by local banks and that means an indirect guarantee. The instructing bank sends by SWIFT message all the

needed details concerning the guarantee and the counter guarantee to the issuing bank in Iran and the Iranian bank then issues the guarantee. (Bank A's representative 2008.) An Iranian bid bond wording can be found in Appendix 4 and a counter guarantee in Appendix 8.

4.1 Issuing a bid bond

As Bank A's representative (2008) stated the following points have to be clearly defined in the guarantee application in order for the bank to be able to issue the bid bond in Iran:

- Guarantee type: bid bond
- Applicant company's official name and address
- Beneficiary company's official name and address
- Tender/invitation number
- Tender closing date (optional but recommended)
- Offer no and date (optional)
- Project description
- Copy of the competitive bidding invitation (optional but recommended)
- Guarantee amount and currency
- Guarantor (if specified), direct / indirect guarantee
- Delivery details of the issued guarantee (person, address and phone number)
- Confirmation of the Iran clause (defined in paragraph 2.4.1)

4.2 Special characteristics in the bid bond wording

"For the sum of ... and undertakes that in case the beneficiary inform the bank that the tender proposal of the applicant has been accepted but the applicant has failed to sign the relevant contract or to submit a good performance guarantee within the assigned period, to pay the sum of ... immediately to the beneficiary upon receipt of the beneficiary's first written demand without its having to present any proof of refusal or any reason or to issue a declaration or to take any other official and/or judicial action." (See Appendix 4: Bid bond wording)

The above part of the bid bond wording defines the guarantee as on first demand guarantee. The beneficiary has to only make a written demand for a payment in order to get the maximum guarantee amount specified in the guarantee wording. The beneficiary does not need to present any documents or other statement to claim the guarantee amount.

The wording defines that the beneficiary has to inform the bank if the principal debtor has failed to sign the relevant contract or to submit a good performance in the given period and the bank undertakes to make the payment. However the issuing bank effects the payment

against the first written demand without any evidences, other official or judicial action of the above mentioned faults.

As already mentioned on first demand guarantees are highly risky especially in a country like Iran. The customer can easily demand for payment under the guarantee and put the pressure for the supplier's side. But it is always good to notice that when the beneficiary makes a demand for payment it puts the business relationship with the supplier in danger. After claiming the guarantee amount and in that sense indicating that the supplier has failed to fulfill his obligations it can be difficult to build a good business relationship between the parties. For this reason the guarantees are quite rarely claimed. (Bank A's representative 2008.)

4.3 Amendments

According to Mr Wancke (2008) the guarantees can be amended during the validity of the guarantee. Amendments are most often related to the expiry dates i.e. the guarantee period is extended. Extensions are handled more closely in the following chapter. Other amendments made in the guarantee wordings can relate to guarantee amount changes (increases and decreases), project description etc. A special feature regarding Iranian bid bonds is that everything else except the standard wording template can be amended. In other words the details given by the principal debtor for the instructing bank can be amended as many times as needed. It is anyhow important to remember the amendments cost and therefore should be avoided when possible.

4.4 Withdraw or extend -request

The request relating to bid bonds are often extend or pay -requests and withdraw or extend -request. One reason to extend a bid bond according to Bertrams is to give more time for the beneficiary to evaluate the tenders. This is a disadvantage for the principal debtor since the planning of the project has to be changed and it increases the cost level. Withdraw or extend -request are much more reasonable for the both parties compared to extend or pay -requests since the principal debtor is able to withdraw its tender and after that the beneficiary is forced to return the guarantee. Or if the principal debtor wants to continue the competitive bidding he can extend the guarantee. (Bertrams 1996, 191.) Unfortunately the requests are most often extend or pay -requests.

Extension process of indirect guarantees:

1. The beneficiary makes an extend or pay -request to the issuing bank
 2. The issuing bank informs by SWIFT the instructing bank and requests for instruction
- (See Appendix 5 is a model Extend or pay -request)

3. The instructing bank informs the principal debtor and requests for instructions whether the guarantee is extended or paid
4. The principal debtor advises the instructing bank to extend the guarantee as requested by the beneficiary or to pay the guarantee amount
5. The instructing bank sends a SWIFT to the issuing bank requesting for extension or pays the guarantee amount to the issuing bank's bank account
6. The issuing bank gives an extension or pays the guarantee amount to the beneficiary
(See Appendix 6: Extend or pay -request)
(Mr Wancke 2008.)

4.5 Validity

Bid bonds sometimes include an extension clause which means that the beneficiary has the right to extend the period of validity upon his request as many times as they want. Extension clause obviously accommodates the interests of the beneficiary but it also has advantages for the principal debtor and the bank. It forces the beneficiary to make the decision before the expiry date whether they have reckoned a possibility of claim or not. If the beneficiary tries to extend or claim the guarantee after the expiry date the guarantee is not valid any more. (Bertrams 1996, 84-85.)

“This undertaking is valid until the last office hour of ... (“the expiry date”) and shall be extendible for the periods requested by the beneficiary. In case the bank is unable or unwilling to extend the undertaking or the applicant does not provide the means for such an extension or does not acquire the agreement of the bank with the extension, the bank undertakes to pay the above sum to the beneficiary without any need for further claim.” (See Appendix 4: Bid bond wording)

As stated by Company X's representative (2008) the guarantee wordings in Iran have to be extend or pay -basis. That means that the guarantee is considered as open ended and the beneficiary or the issuing bank may extend the validity of the guarantee during the validity period of the guarantee. The guarantees are often extended by the Iranian banks in order to secure possible claims of the beneficiary until the beneficiary explicitly informs the bank that there is not going to be any demand for payment and the guarantee can be cancelled.

In cases where the bank is unable or unwilling to extend the guarantee are very rare. This might happen if the banks do not rely on each other any more or if the instructing bank has big doubts about the principal debtor's financial position. (Mr Wancke 2008.)

4.6 Cancellation

Bid bonds should expire once the obligations in the bid bond wording have been fulfilled or when the demand of payment has been paid. The obligations stated in Iranian bid bond wording are to sign the relevant contract and submit a good performance guarantee within the assigned period.

The guarantees are not easily released by the customers in Iran. For some reason the customers do not return the guarantees back to bank for cancellation when all the obligations under the guarantee has been fulfilled and completed. One reason could be at least with the governmental customers that the governmental operators have to exercise a long process of internal approvals and additionally have to obtain approvals from a guarantee committee in order to release guarantees. Other reason could be that the guarantee is an instrument to enforce any demands towards the supplier. (Company X's representative 2008.) However there is often a little incentive for the customer to return the original guarantee document upon the expiry date or completion (Bertrams 1996, 201).

The expiry dates in Iranian guarantees and counter guarantees are not definitive. The enforceability of the expiry dates are not commonly understood fact. (Bertrams 1996, 84-85.) Therefore the banks do not release the counter guarantees until they have been released from the liabilities under the guarantees.

4.7 Laws of Iran

"This guarantee shall be governed by and construed in accordance with the laws of Iran and shall be subject to the exclusive jurisdiction of the Iranian courts." (See Appendix 4: Bid bond wording)

The above mentioned clause is in the Iranian bid bond. It clearly states that the guarantee is governed by the laws of Iran and subject to the exclusive jurisdiction of the Iranian courts and therefore there is no place for misunderstanding. If any court judgements are made regarding the guarantee the right place for those is the Iranian court. The clause is standard in Iranian guarantees and required by the Central Bank of Iran.

According to Company X's representative (2008) Iranian guarantees are released only after they have been returned to the issuing bank for cancellation. This practice comes from the laws of Iran.

5 Performance guarantee in Iran

According to Company X's representative (2008) the governmental customers require performance guarantees due to governmental regulations. The purpose of guarantees is to secure the performance of the deliveries or services (often including warranty services) and payment of liquidated damages for the event of bankrupt of the supplier, legal problems with the supplier and the embargos. Private customers do not require mandatory performance guarantees due to governmental regulations but they need to at least fulfil their guarantee obligations towards their governmental customers. Generally customers in Iran require guarantees from their suppliers.

An Iranian performance guarantee wording can be found in Appendix 5 and a counter guarantee in Appendix 8. The same counter guarantee form is used with bid bonds.

5.1 Issuing a performance guarantee

As Bank A's representative (2008) stated the following points have to be clearly defined in the guarantee application in order for the bank to be able to issue the performance guarantee in Iran:

- Guarantee type: performance
- Applicant company's official name and address
- Beneficiary company's official name and address
- Contract number and date
- Contract amount and currency
- Project description
- Copy of the contract (optional but recommended)
- Guarantee amount and currency
- Guarantor (if specified)
- Delivery details of the issued guarantee (person, address and phone number)
- Confirmation of the Iran clause (defined in paragraph 2.4.1)

5.2 Special characteristics in the performance guarantee wording

"With reference to the contract No ... between ... (the beneficiary) and ... (the principal debtor) in connection with the limited tender No ... in respect of supply of ... (project description), as described in proforma invoice No ... dtd ... between ... (the beneficiary) and ... (the principal debtor), in case of failure by ... (the principal debtor)(herein after referred as the issuing party) in the due fulfilment of its obligations, which will be determined upon ... (the beneficiary), we, ... (bank), undertake to pay the amount demanded for any reason immedi-

ately upon the written request of ... (the beneficiary) and without the need for any proceedings through any legal or judicial authority and also without any need to prove the failure, up to the maximum amount of ... (in words ...) to ... (the beneficiary) and/or any party upon the request of ... (the beneficiary) provided the maximum amount payable does not exceed the amount stated above.” (See Appendix 5: Performance guarantee wording)

The above Iranian performance guarantee is clearly on first demand guarantee without any statement. The contract number, the parties, the project description, the issuing bank and the maximum guarantee amount are clearly defined in the guarantee wording. According to Mr Wancke (2008) the Iranian guarantees are paid without stating any reason or proofing any failure. The guarantee wording defines that the beneficiary is obligated to demand for payment when the principal debtor has failed to fulfil its obligations.

The issuing bank is obligated to pay in case of a demand maximum the amount stated in the guarantee wording. If the claim is unfair there are a few things to be done. Demands for payments and frauds are investigated more closely in chapter 8 (Demand for payment).

5.3 Amendments

Amendments made to performance guarantees are quite similar to bid bond amendments. The blank points in the wording can be amended. The most common amendment to performance guarantee is an extension. The extensions are defined more closely in the following paragraph. (Mr Wancke 2008.)

The performance guarantee wording as well as the bid bond wording is required by the Central Bank of Iran and cannot be amended.

5.4 Extend or pay -request and validity

Extend or pay -request is made by the beneficiary to either extend the period of validity of the guarantee or to get the payment. Extend or pay -requests are widespread and a common practice with on demand guarantees. There are several reasons to make the request. The first one could be to allow the beneficiary more time to observe his rights under the guarantee, for example to solve the difficulties concerning the completion of the contract. A second reason could be that the beneficiary has not yet made the decision or considers claiming the guaranteed amount. On the other hand the extension request can be done because of the bureaucratic in the beneficiary's company or to get some time to decide whether the guarantee is still needed or not. One reason could be that the beneficiary wants to put pressure on

the principal debtor to make the contractually agreed works done. (Bertrams 1996, 189.)
Extend or pay process is defined more closely in paragraph 4.

“This guarantee shall be valid up to ... and shall be extended for any time upon ... (the beneficiary) request. In case the bank does not extend the guarantee and/or the issuing party has not fulfilled the needed arrangements for extension thereof, then the bank undertakes to pay the amount of this guarantee to ... (the beneficiary) and/or any other party upon the request of ... (the beneficiary).” (See Appendix 4: Performance guarantee wording)

Like bid bonds also performance guarantees in Iran are extend or pay -basis. Above mentioned clause from Iranian performance guarantee wording includes the beneficiary’s right to extend the guarantee at any time.

As stated by Company X’s representative (2008) the guarantee wordings in Iran have to be extend or pay -basis. This means that the beneficiary is justified to demand the extension for the guarantee or otherwise the bank is obligated to pay the demanded amount not exceeding the maximum guarantee amount specified in the guarantee wording. This method is very risky for the principal debtor since the beneficiary can demand the extension as many times as they want during the validity of the guarantee. This of course adds the costs. From the experience of Company X’s representative Iranian performance guarantees are extended many times.

When a guarantee is extended also the counter guarantee extends. So it does not matter whether the counter guarantee is extended or not according to the general rule also the counter guarantee extends. All other terms and conditions remain unchanged. (Bertrams 1996, 193.)

5.5 Cancellation

Performance guarantees should expire once the obligations stated in the guarantee wording have been fulfilled. In Iranian guarantee wordings those were the obligations mentioned in the contract. The difficult part is that the beneficiary determines when the obligations of the contract have been fulfilled and the guarantee can be released.

If possible the termination event should be defined as clearly as possible to avoid any confusion or misunderstanding in the future. Unfortunately this is not possible with Iranian guarantees and the termination is unclear.

The same information as given in the paragraph 4.6 also applies to cancellation of performance guarantees.

5.6 Laws of Iran

“This guarantee shall be governed by and construed in accordance with the laws of Iran and shall be subject to the exclusive jurisdiction of the Iranian courts.” (See Appendix 5: Performance guarantee wording)

Performance guarantees in Iran include the Iranian law as applicable law. Even though it does not matter if it is mentioned or not. The applicable law is the issuing bank's country's law if it has not been mentioned separately in the guarantee wording.

As stated earlier because of the laws of Iran the guarantee has to be returned for cancellation before the issuing bank is able to release the guarantee.

6 Bank's counter guarantee

The request from the instructing bank to the issuing bank includes the two following elements: the request to issue a guarantee in accordance with the given information and the wording and the expression of undertaking the reimbursement. The undertaking is commonly referred to as a counter guarantee. The counter guarantee is issued by the instructing bank in favour of the issuing bank but for the account of the principal debtor. (Bertrams 1996, 135.)

As mentioned before the instructing bank is obligated to give the counter guarantee to the Iranian bank in order to issue a guarantee. The Iranian counter guarantee is very detailed and always includes the same information which is required by the Central Bank of Iran. The latest change in the counter guarantee wording is that the payment shall be made in EUR or any other convertible currency. This way the Iranian bank assures that it will get the payment regardless of upcoming regulations and sanctions in the future. (Bank A's representative 2008.) Appendix 8 is a model of counter guarantee to Iranian bank.

The Iranian counter guarantee includes the following details:

- confirmation that the instructing bank undertakes to pay any amount not exceeding the guarantee amount plus the commissions, the charges and the interest (the interest is defined in the wording)
- the payment shall be made immediately without requiring any proofs
- the payment shall be made in EUR or any other convertible currency
- expiry date plus further two months

- automatic extendable clause
 - guarantee is governed in every respect by the laws of Iran
- (See Appendix 8)

7 Costs

The guarantees are bank's products and they charge for their services and support. This thesis includes HSBC bank UK International Business Banking Price List (2008) as a reference. It is however important to remember that the prices are often agreed separately with the bank and the customer.

The price level is related to the risk that the bank has to take when issuing a guarantee. The bank rates their customers and after that considers the appropriate pricing level. The costs of the guarantee are important to take into account when pricing the main contract in order to allocate the costs for the contract and further for the customer. (Bank A's representative 2008.) The bank guarantee charges consist of the following costs.

The current market situation and the turmoil in the financial markets have forced the banks to reprice their products. This has also affected to guarantee pricing.

7.1 Issuance fee

Issuance fee covers the cost of handling the new guarantee application and issuing the guarantee. Issuance fees vary a lot but my experience is that normally those are between 50 - 150 EUR.

7.2 Guarantee commission

According HSBC UK the guarantee commission is normally charged quarterly in advance on the guarantee issuance day and it is 2.2% p.a. (0.55% per quarter), minimum 75 GBP per quarter. The commission fee is covering the bank's risk and the bank's capital adequacy requirements (Norde. 2006, 8).

7.3 Amendment fee

HSBC UK (2008) charges of amendment 40 GBP, plus additional commission charges if the amendment involves an increase in the value of the guarantee. If the amendment is a reduction of the guarantee amount, HSBC UK charges 50 GBP when documents are promptly

checked. An amendment fee is a flat fee charged when the guarantee amount, the guarantee wording or the period of validity is amended (Nordea 2006, 8).

7.4 Cancellation fee

When the guarantee is not needed any more or the validity of the guarantee has ended the bank charges a cancellation fee. HSBC UK charges £40 for cancellation prior to expiry date, plus transmission costs.

7.5 Other costs

There are also other costs involved when issuing a bank guarantee. The bank charges the postage, SWIFT and fax charges it has paid regarding the issued guarantee. Also if the guarantee has been advised through beneficiary's local bank, the local bank charges some additional fees. (Nordea 2006, 8.)

Sometimes the guarantees get lost and a duplicate is needed to replace the existing guarantee. HSBC UK will charge a future commission on the replacement item only, once the former guarantee is cancelled.

7.6 Indirect guarantee expenses

If the guarantee is not issued by the first bank (direct guarantee) there will also be the issuing bank's expenses (indirect guarantee). The issuing bank charges the issuance fee, the commission, stamp duties etc. The prices vary a lot by different countries and banks. (Nordea 2006, 8.) From Mr Wancke's (2008) experience the charges easily at least doubles compared to direct guarantees and therefore direct guarantees are always recommended if possible and accepted by the beneficiary.

From the experience of Mr Wancke (2008) the commissions of Iranian banks are about 1 % p.a. However he reminds that the charges vary a lot between different banks and in case the guarantee amount is big, it is highly recommended to agree the commissions beforehand with the local bank. This way the pricing level can decrease and there will be no surprises during the validity period of the guarantee.

8 Demand for payment

Demands for payments are quite unusual since guarantees are considered as safety devices. Approximately three to five per cent, or even less, of the guarantees are claimed. The most

important point is to check that all terms and conditions have been met otherwise the claim is refused and invalid. (Bertrams 1996, 219-220.)

The demand for payment has to be made in writing to the issuing bank by beneficiary's authorized person. The request must relate to the principal contract which has been guaranteed. The claim must be made on or before the expiry date and the claimed amount can be at maximum the guaranteed amount specified in the guarantee document. (Bertrams 1996, 221-226, 235, 241.)

Demand for payment process:

1. The beneficiary makes written demand for payment to the issuing bank.
2. The issuing (local) bank informs the instructing bank about the claim and the exact demanded amount. They ask the instructing bank to make the payment immediately and after the payment has been made the instructing bank is released from all of your obligations towards the guarantee, if the demanded amount is the maximum amount of the guarantee.
3. The instructing bank informs the principal debtor and requests for instructions within maximum two days.
4. The principal debtor investigates whether the claim is justified or not and informs the instructing bank accordingly.
5. If the demand is justified, the case is very clear and the bank effects the payment. If it is not justified there are few actions which have to be made quickly. The easiest way is that the beneficiary withdraws the demand from the bank.

(Company X's representative 2008.)

Unjustified demands are studied more closely in paragraph 8.2 Fraud.

8.1 Bank's role

The counter guarantee defines that the principal debtor is forced to pay all the payments made under the related guarantee unless the payment has been unfounded. The difficult part is to settle out whether the bank has made the payment well-founded or not. The claim must often be paid in such a short period that the bank has only limited time to get the settlement. Therefore the bank has to state the settlement made until the payment. (Hemmo, 2001, 292.)

According to Bank A's representative (2008) the claims are very rarely compared to the number of the issued guarantees. More often the beneficiaries make extend or pay -requests. Bank's role in Iranian claim is to pay the demanded amount (maximum the guarantee amount) immediately as defined in the counter guarantee. There is not much time to think about the

options. Anyway the bank is obligated to inform the principal debtor when they have received the demand for payment before they make the payment to the Iranian bank. From Mr Wancke's (2008) experience the claims has to be paid within five days otherwise bank's reputation falls into disrepute.

8.2 Fraud

According to Company X's representative (2008) the frauds are not common with Iranian beneficiaries but have to be taken into consideration especially with the Iranian private customers. When the fraud has been detected it should be investigated and settled out immediately very carefully.

The fraud arises if the conditions and terms of the contract have been fulfilled and regardless of that the demand for payment has been made by the beneficiary. In practice the demand for payment should not be paid in the event of fraud. However the fraudulent claims are always very complicated issues. First demand guarantees are especially problematic since the guarantees themselves justify the beneficiaries to make the claims without proving any defaults. The fraudulent demands have to be settled out case by case. (Bertrams 1996, 257 & 276-277.)

There are a few actions that can be done if a fraud has been detected. The easiest way is that the beneficiary withdraws the claim immediately from the issuing bank. The other options are studied in the following paragraphs.

According to Company X's representative (2008) the only possibility within local jurisdiction is to proceed with obtaining an injunction relief as an interim measure of protection. If this can be done the local bank does not pay the demanded amount. Such an injunction requires that a claimant provides the Administration of Justice with a security, equal to the amount of claim and the local authorities proceed to issue such an injunction. This kind of process is in accordance with the Iranian Civil Procedure Codes. The only way to prevent the payment is to obtain a junction by a court against the issuing bank blocking their payments to the beneficiary.

According to Mr Wancke (2008) if an unfair call has been made and the principal debtor has not acted against the underlying contract the instructing bank is able to get a garnishee order from the city administrative court. The needed actions have to be made quickly since there is not much time before the payment has to be paid.

9 Conclusions

The main target of this thesis is to clarify and compile the issues related to guarantees and especially the Iranian bid bonds and performance guarantees. The subject is studied from the supplier's side. This thesis can be used as a guide for companies which have Iranian customers and are therefore obligated to issue guarantees in favour of their customer. Guarantees are a workable method in international trade finance and it is important to have basic knowledge of guarantees. International customers often require guarantees to secure the advance payments, the performance of the goods etc.

The objectives of this thesis have been achieved. This thesis studies the guarantees overall and expands the information regarding Iranian bid bonds and performance guarantees. This thesis is useful for companies which have Iranian bank guarantees.

Iran is a challenging country to run business in at the moment. The situation in the world and the unsteadiness of the Middle East makes it even more difficult. Dealing with Iranian companies and banks is strictly regulated. The guideline is that the company must operate according to the regulations and sanctions given by the United Nations and the European Union. The confirmation related to EU regulation 423/2007 has to be provided to banks with every new guarantee and in addition some banks require the same confirmation with the extension of an old guarantee.

The main features to be noticed of the Iranian bank guarantees are the automatic extension clause, the demand for payment without a statement, releasing the guarantees and the laws of Iran. The beneficiaries are automatically able to extend the validity of the guarantees as many times as they request. This method extends the validities of the guarantees often for a long period. The demand for payment is valid without any statement that the supplier has failed to fulfil its obligations under the contract. Therefore the demands have to be investigated very carefully and the possibility of fraud has to be taken into consideration.

The laws of Iran have been the main challenge during this thesis. Material cannot be found easily and the content is very uneasy to read and understand. The main points have been studied but more in-depth knowledge has to be found somewhere else. A good subject for a legal student could be to investigate the effect of Iranian law to guarantees.

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Appendixes

Appendix 1 Bank interview; Bank A

Time and place	30.10.2008, 14.30-16.00, Helsinki
Attendance	Bank's representative Laura Ahvenainen

1. Essential things to remember when issuing a bank guarantee
 - Main points in bid bonds which has to be known
 - Main points in performance guarantees, what has to be known
2. Special characteristics in Iranian bid bonds
3. Special characteristics in Iranian performance guarantees
4. What is bank's role in claims?
 - Do you receive claims often?
5. Challenges in the laws of Iran
 - How the laws of Iran differ from the European laws?
6. Co-operation with Iranian banks
 - What kind of limitation there are?
 - Is there many available banks?
7. Own opinion of the Iranian banks/guarantees
 - How do Iranian banks differ from European banks?
8. "Iran clause"
 - Where does the clause come from, who requires it?
 - How long has it been required?
 - Is there going to be other requirements in the future?
9. Average cost estimation of direct /indirect guarantee
 - Your bank's charges
 - Local bank's charges
10. Any other points to comment regarding guarantees in Iran

Appendix 2 Bank interview; Bank B

Time and place	7.11.2008, 14.00- 16.00, Helsinki
Attendance	Peter Wancke Laura Ahvenainen

1. Essential things to remember when issuing a bank guarantee
2. How credit limit is created?
 - What things are included?
 - Process with companies who do not have credit limit?
3. Special characteristics in Iranian bid bonds
 - Amendments to bid bonds
4. Special characteristics in Iranian performance guarantees
 - Amendments to performance guarantees
5. Extension process
 - Please explain the whole process of extension starting from beneficiary's request.
 - Anything specific in Iranian extensions
6. What is bank's role in claims?
7. Challenges in the laws of Iran
 - How the laws of Iran differ from the European laws?
8. Co-operation with Iranian banks
 - What kind of limitation there is?
 - Is there many available banks?
 - How Iranian banks differ from European banks?
9. Average cost estimation of direct/indirect guarantee
 - Issuance fee, amendments, commission etc.
 - Costs of the local banks in Iran
10. Any other points to comment regarding guarantees in Iran

Appendix 3 Interview of Company X's representative

Time and place	By emails during 15.10- 27.10.2008
Attendance	Company X's representative Laura Ahvenainen

1. Main things to remember when entering into Iranian business

- Risks that has to be taken into account?
- Special characteristics of Iranian customers.

2. Own opinion of the Iranian banks and the guarantees in Iran

- Why the customers require guarantees?
- Banks want to use their own standard wordings for guarantees and counter-guarantees.
- What should be taken into account of the content of the wordings?

3. Special features of bid bonds and performance guarantees?

4. Guarantee as a risk management option

- Are guarantees workable method or are those sometimes issued in vain?
- Should the customers rely more on their suppliers?

5. Possibility of claims

- How easily do the customers claim guarantees?
- What are the responsibilities for the customer and the supplier?
- Bank's role in claims.
- Is there a possibility of fraud?

5. Guarantees are extended quite often and some guarantees several times

- Is this because we haven't done our part properly or do the projects delay often for some other reasons?
- What are the main reasons for extensions?

6. Cancellations can be done only when the guarantees are returned to banks for cancellation.

- Do the customers easily return the guarantees, if not why?

7. Estimate of the costs of the guarantee per year (per cent of the contract value)?

8. Any other points to comment regarding guarantees in Iran

Appendix 4 Bid bond wording

Bid bond

Whereas ... (applicant company) (hereinafter referred to as the applicant) wishes to participate in the lower tender bid no ... dated ... relevant to ... bank ... (hereinafter referred as the bank) hereby guarantees the applicant against ... (beneficiary company)(hereinafter referred to as the beneficiary)

For the sum of ... and undertakes that in case the beneficiary inform the bank that the tender proposal of the applicant has been accepted but the applicant has failed to sign the relevant contract or to submit a good performance guarantee within the assigned period, to pay the sum of ... immediately to the beneficiary upon receipt of the beneficiary's first written demand without its having to present any proof of refusal or any reason or to issue a declaration or to take any other official and/or judicial action.

This undertaking is valid until the last office hour of ... ("the expiry date") and shall be extendible for the periods requested by the beneficiary. In case the bank is unable or unwilling to extend the undertaking or the applicant does not provide the means for such an extension or does not acquire the agreement of the bank with the extension, the bank undertakes to pay the above sum to the beneficiary without any need for further claim.

This guarantee shall be governed by and construed in accordance with the laws of Iran and shall be subject to the exclusive jurisdiction of the Iranian courts.

Appendix 5 Performance guarantee wording

Performance guarantee

With reference to the contract No ... between ... (the beneficiary) and ... (the principal debtor) in connection with the limited tender No ... in respect of supply of ... (project description), as described in proforma invoice No ... dtd ... between ... (the beneficiary) and ... (the principal debtor), in case of failure by ... (the principal debtor)(herein after referred as the issuing party) in the due fulfilment of its obligations, which will be determined upon ... (the beneficiary), we, ... (bank), undertake to pay the amount demanded for any reason immediately upon the written request of ... (the beneficiary) and without the need for any proceedings through any legal or judicial authority and also without any need to prove the failure, up to the maximum amount of ... (in words ...) to ... (the beneficiary) and/or any party upon the request of ... (the beneficiary) provided the maximum amount payable does not exceed the amount stated above.

This guarantee shall be valid up to ... and shall be extended for any time upon ... (the beneficiary) request. In case the bank does not extend the guarantee and/or the issuing party has not fulfilled the needed arrangements for extension thereof, then the bank undertakes to pay the amount of this guarantee to ... (the beneficiary) and/or any other party upon the request of ... (the beneficiary).

This guarantee shall be governed by and construed in accordance with the laws of Iran and shall be subject to the exclusive jurisdiction of the Iranian courts.

Appendix 6 Extend or pay -request

YOUR C/G NO... OUR L/G NO...

PLS BE INFORMED THAT AT THE BENEFICIARY'S REQUEST, WE HAVE EXTENDED THE VALIDITY OF THE A/M G. UPTO: ..., BEARING EXPENSES FOR ..., SO PLEASE CREDIT OUR A/C WITH ... WITH THE A/M SUM, CONFIRMING YOUR C/G EXTENSION UP TO THE SAID DATE PLUS 30 DAYS BY URGENT AUTHENTICATED TELETRANSMISSION.

HOWEVER, IF WE DO NOT RECEIVE YOUR CONFIRMATION ON THE ABOVE EXTENSION AND THE RESPECTIVE FEES WITHIN 15 DAYS, WE ASSUME YOU WISH TO PAY THE G AMOUNT IN ITS EURO EQUIVALENT THROUGH OUR A/C WITH ...

PLS MENTION OUR L/G NO... IN YOUR CREDIT ADVICE AND CORRESPONDENCE.

REGARDS,

...

Appendix 7 Extension

(Banks Name)
(Banks Address)

Extension

Company name beneficiary

We hereby extend the validity of L/G No. ... issued in the name of (Applicant company) until ... (new expiry date) other terms and conditions remain unchanged.

Yours faithfully

(Banks signatures)

Appendix 8 Bank's counter guarantee

TO: ...(IRANIAN BANK)

'COUNTER GUARANTEE FOR ...(GUARANTEE TYPE)'

IN CONSIDERATION OF YOUR HAVING AGREED TO ISSUE ...(GUARANTEE TYPE) FOR (CURRENCY AND AMOUNT) IN FAVOUR OF (BENEFICIARY) ON BEHALF OF ...(APPLICANT) ... IN CONNECTION WITH THE L/C NO. ... ISSUED BY ... BRANCH ON ... (DATE) ... , WE ... (NAME OF THE BANK) ... HEREBY IRREVOCABLY AND UNCONDITIONALLY UNDERTAKE TO PAY TO YOU IMMEDIATELY ANY AMOUNT NOT EXCEEDING (CUR AMOUNT) PLUS YOUR COMMISSION AND CHARGES PLUS THE INTEREST AT SUCH RATE INDICATED BELOW AGAINST YOUR SIMPLE DEMAND BY AUTHENTICATED SWIFT, TELEX, CABLE OR AIRMAIL.

A DEMAND AS SUCH SHALL BE CONCLUSIVE AND THE AMOUNT SHALL BE PAID BY US TO YOU IMMEDIATELY AND WITHOUT REQUIRING YOU TO RESORT TO ANY ADMINISTRATIVE, LEGAL OR OTHER AUTHORITIES OR TO PROVIDE ANY PROOF WHATSOEVER.

IN CASE OF DEMAND OF THE BALANCE OF THIS GUARANTEE, INTEREST SHALL ACCRUE FROM THE DATE THAT THE ADVANCE PAYMENT WAS INITIALLY EFFECTED BY THE BENEFICIARY TO THE APPLICANT UPTO THE DATE OF ACTUAL REPAYMENT CALCULATED AT THE RATE OF THREE MONTHS LIBOR PLUS ONE PERCENT PER ANNUM.

IN CASE OF DELAY IN THE PAYMENT OF THE AMOUNT DEMANDED UNDER THIS GUARANTEE, INTEREST OF TWO PERCENT ABOVE OVERNIGHT LIBOR ACCRUES TO THE AMOUNT DUE AND SHALL BE PAID TO YOU.

THIS UNDERTAKING AND OBLIGATION SHALL BE VALID FOR AN ORIGINAL PERIOD ENDING AT THE LAST OFFICE HOUR ON ...(DATE) ... ITS EXTENSION FOR ANY ADDITIONAL PERIOD SHALL BE SUBJECT TO YOUR INSTRUCTION OR APPROVAL.

IN CASE WE ARE UNABLE OR NOT PREPARED FOR WHATSOEVER REASON TO EXTEND THE PERIOD REQUESTED BY BENEFICIARY OR ANY PERIOD EXTENDED THEREAFTER, WE SHALL THEN IMMEDIATELY AND SIMULTANEOUSLY PAY YOU THE AMOUNT REQUESTED BY BENEFICIARY WITHOUT REQUIRING ANY DEMAND BY YOU. THIS GUARANTEE WILL AUTOMATICALLY BE EXTENDED ACCORDING TO THE EXTENSION AT YOUR GUARANTEE WHICH WILL BE EFFECTED AT THE BENEFICIARY'S REQUEST FOR ANY PERIOD ASKED BY THEM, WITHOUT NECESSITATING ANY PRIOR CONSULTING WITH US, AND IN CASE OF OUR NON AGREEMENT TO EXTEND, WE WILL EFFECT PAYMENT TO YOU, WITHOUT YOUR HAVING TO PROVIDE ANY PROOF OR DOCUMENTATION. SHOULD, UNTIL THE EXPIRY DATE OF THE GUARANTEE, OR AFTER SUCH EXTENDED DATES, NO REQUEST FOR EXTENSION BE RECEIVED BY US, WE WILL EXTEND THE VALIDITY OF ABOVE MENTIONED COUNTER- GUARANTEE FOR A PERIOD OF TWO MONTHS.

THIS UNDERTAKING AND OBLIGATION SHALL BE BINDING ON AND PAYABLE BY US, OUR SUCCESSORS AND ASSIGNS. ALL PAYMENTS SHALL BE EFFECTED BY ACTUAL REMITTANCE OF THE AMOUNT TO THE ACCOUNT AS NOTIFIED BY YOU IN WRITING.

IF ANY AMOUNT PAYABLE UNDER THIS GUARANTEE IS NOT POSSIBLE TO BE PAID IN EUR, PAYMENT WILL BE EFFECTED IN ANY FREELY CONVERTIBLE CURRENCY CALCULATED AT THE OFFICIAL BUYING RATE OR YOUR CENTRAL BANK AND ANY WHERE AS DETERMINED BY YOU.

THIS UNDERTAKING AND OBLIGATION WHATSOEVER SHALL BE EXCLUSIVELY GOVERNED IN EVERY RESPECT BY THE LAWS OF THE I. R. OF IRAN AND THE COURTS IN IRAN SHALL HAVE SOLE JURISDICTION FOR EVERY AND ALL MATTERS RELATED THERETO.